The FRC, Kingman, auditors and an elephant or two in the room?

In a recent interview with the Financial Times the business secretary, Greg Clark, said that he had asked Sir John Kingman to consider the near monopoly that the Big Four auditors have on FTSE100 audits and to look at ways to remove conflicts of interest. He also wanted him to consider whether the auditors of large listed companies should be appointed by a public body. Separately, he has written to Andrew Tyrie, the newly appointed head of the Competition and Markets Authority (CMA), asking him to examine competition in the audit industry as soon as possible. So what is there to like or dislike about Greg Clark's calls for action?

The Kingman Review

There is no doubt that Sir John Kingman and his review team will be considering whether the FRC is unduly influenced by the auditors and, in particular, the large audit practices. The FRC draws many of its management and staff from the large audit firms. This is logical, but there are real concerns that it has resulted in 'regulatory capture'. He may also legitimately question why the FRC has failed to promote a robust debate on increasing concentration of audit work into the hands of the Big Four audit firms – PWC, EY, KPMG and Deloitte – in recent years.

However, Sir John Kingman made it very clear from the outset that it was not within his remit to look at or make recommendation on issues of competition in the audit market. I for one would not be happy if, four months into the review period and two months since the deadline for consultations ended, the terms of the review were suddenly to change – and in a fairly fundamental way. It is reasonable that someone should look at the oligopoly of the Big Four and at conflicts of interest; however, it should not be Sir John Kingman. As with so many ideas that politicians come up with, there is a superficial eye-catching neatness and simplicity to them which fails to acknowledge deeper complexities in the issue to be addressed. Greg Clark's request to Sir John Kingman is a good example.

Competition in the audit market

Concerns about lack of competition in the audit market have hit the headlines as a result of the demise of Carillion. It is depressing that the issue itself is not new. As mentioned above, the FRC should have been encouraging a robust debate on this for a number of years now. The key question is, what should be done about it?

Simply breaking up the big four auditors into smaller practices is unlikely to achieve very much. It is likely to be slow, costly and complicated. It is also debatable whether the 'Slightly-Smaller-Eight' (or whatever) would be able to meet the needs of some FTE 100 multinationals.

Another option is to ban audit firms from non-audit work and, in effect, forcing them to hive off their consultancy businesses. In some respects this sounds attractive. It helps to deal with the suspicion that some audit contracts are tendered at low rates in order to build a profitable relationship with clients for non-audit work. It also helps to provide an inside-track for getting other advisory work. It makes it much easier to ensure a steady flow of lucrative non-audit work, even if there are strict limits on how much you can do. EU rules require that fees from non-audit services should not exceed 70% of average audit fees over the last three years. Some audit work, such as the provision of tax and payroll services, is totally off-limits. So are 'services that involve playing any part in the management or decision-making of the audited entity'. But what does that mean? Does it rule out lucrative work on business strategy? It is a grey area. Under current EU rules the external audit contract has to be retendered at least every ten years and rotated at least every twenty years. Combining this requirement with limits on non-audit work compounds the competition problem. What if a FTSE 100 company goes out to tender for its external audit contract and one of the big four is already doing the internal audit (Deloitte was Carillion's internal auditor), while another is doing tax work and providing consultancy on a major IT contract? Potentially, the company now has a choice of just two firms it deems capable of handling its audit requirements – one of which is the incumbent.

There are, therefore, some good reasons for suggesting that we should have specialist audit practices that do not do any non-audit work. However, forcing the Big Four to divest themselves of their non-audit work could be as difficult and complex as any other break-up process. Furthermore, it might do little to solve the problem. Remember that the problem, as defined in the context of Carillion, is to do with the quality of audit work. That is what has prompted the whole debate about auditors and the UK audit market. Is more competition the answer to the quality problem? Is there even a quality problem? Some argue that there isn't and that the problem has more to do with misunderstandings over the role of the external audit and unrealistic expectations on the part of investors.

Accounting standards

One area in which a review is almost certainly needed is that of accounting standards. Since the 1970s fair value accounting has increasingly become the accepted norm. From the 1990s fair values started to replace historical cost numbers in the balance sheet, first in the US, then, with the arrival of IFRS accounting standards in 2005, across the EU. As one investor commented to the FT (Auditing in Crisis - 2.8.18), 'The problem with fair value accounting is that it is very difficult to differentiate between mark-to-market, mark-to-model and mark-to-myth'. In theory, fair value accounting should not preclude sound audits but it does seem to make them harder, particularly as it requires strong standards governing distribution of dividends and capital maintenance. This is almost completely lacking from current fair value standards such as IFRS. Consequently, there is plenty of scope for bonus-hungry management to stretch the boundaries created by looser evidential standards and increase the pressure on auditors.

What next?

Greg Clark would do better to call for a review of accounting standards, despite the fact that this is not the attention-grabbing, vote-winning initiative that politicians like to promote. In the meantime, it would be interesting to hear from UKSA members, perhaps through articles or correspondence in TPI, what their views are.

The FRC is also planning this year's event for UKSA and ShareSoc members. It will be held on the afternoon of Monday, 3rd December at the FRC's offices at 125 London Wall and is very likely to include sessions on the Kingman Review, the future of audit and the future of company reporting. It promises to be another lively, interesting and very topical event. Further details are provided below.